C.D. Howe Institute

Commentary

SEPTEMBER 1985

KEEPING AN EYE ON THE BALL

Summary: The federal government's economic strategy as initially conceptualized in 1984 was sound but its implementation has not been. One reason is that the government has become bogged down by the conflicting claims of special-interest groups. However, it still has a few major opportunities to improve Canada's long-term economic growth potential. It can achieve this strategic goal by further slowing the accumulation of federal debt, increasing the economy's flexibility, strengthening the social safety net, and changing trade policy. Taking some of these tough actions will inevitably create short-term winners and losers. The government, as steward of the national interest, should listen to interest groups. But it then has a responsibility to act, keeping in clear view of everyone the strategic goals that are in the long-term national interest.

A year ago, C.D. Howe Institute **Commentary** called on the newly elected government of Prime Minister Brian Mulroney to put Canadian economic policy on a new course -- one that would renew and sustain a noninflationary growth momentum. That issue of **Commentary** explored some of the required changes in strategy and recommended both a long-term growth framework and a short-term action program focusing on reducing the deficit, managing Canada's human resources, promoting technological change, and achieving trade and investment objectives. Now, as the Mulroney government enters the second year of its mandate, we re-issue the call because of our concern that Canada may "drop the ball".

The new government has had both a unique opportunity and a set of favorable economic circumstances to move ahead, and it made an excellent start with its November 1984 paper, A New Direction for Canada: An Agenda for Economic Renewal. To be sure, no responsible observer of the economic scene could have expected instant solutions to Canada's deep-seated problems. But the promise of a new direction has still to translate into corresponding action. Economic policy today gives the impression of drifting; neither a clear sense of purpose nor a strategic commitment is yet obvious. With the release of the final report of the Macdonald Royal Commission at the time this **Commentary** went to press, the government has been handed a blueprint of considerable signficance and an opportunity to halt the drift.

In the November paper, the government committed itself to a growth-oriented strategy. This commitment was based on certain key assumptions: that the market would have to be allowed to work more freely; that the mix of public- and private-sector activity would have to change; that obstacles to private-sector investment would have to be removed; and that the fires of business and consumer demand could be rekindled by restoring confidence in Canada's job and growth prospects.

The paper acknowledged that "a major reason for our poor performance has been the failure of the Government of Canada to deal with the real problems." It further stated that the new government had "a clear sense of the direction" in which it wished to lead the country, subject to taking into account the views of a broad cross section of the Canadian community.

In the course of the past year, the government has initiated an unprecedented series of consultative activities. These have included private meetings with representatives of business, labor, professional groups, the provinces, and many others, as well as public discussions that culminated in the National Economic Conference of March 1985. In a different vein, but also in the consultative spirit, the government has commissioned various task forces to examine and report on ways to improve the efficiency and effectiveness of its own activities. The publication of discussion papers by several government departments has represented yet another step in this process.

By placing heavy emphasis on the consultative process, the government presumably has had three major purposes in mind:

- consensus-building, a dramatic -- and welcome -- change in style from the confrontational approach to decisionmaking, particularly in federal-provincial relations, that characterized much of the preceding fifteen years;
- listening to new ideas, to open up the decisionmaking process by encouraging policy inputs from new sources to balance out those from groups such as the federal bureaucracy; and
- reducing expectations of government, by allowing various private groups to participate in, and thus be responsible for, key economic decisions.

In a few policy areas -- energy, tax collection, foreign investment, and federal-provincial relations -- the government had done its homework before it was elected. In these areas, it moved quickly to implement positive policy changes. But in other important policy areas, the new government was unprepared to deal with complex issues requiring tough decisions. The consultation exercise bought the government time but too often ended in confusion rather than consensus.

If the consultative process is to be fruitful, the government, in deciding its course of action, has to manage it by constantly weighing the often-conflicting interests of particular groups against those of the nation. During the past year, however, this process seems to have become an end in itself rather than an instrument of strategic decisionmaking. The government has failed to keep the economy's long-term strategic goals in view of everyone; instead, it has behaved at times like a football player who turns to the crowd to obtain a sense of the direction in which to run. By appearing to respond to the most insistent and articulate interests, the government has sent out a signal: if an offended group organizes itself effectively, it can successfully block a change in policy that would harm its own interests, even if such changes would serve long-term objectives.

In a sense, the challenge the federal government now faces may be more difficult than it was a year ago. The government should be prepared to live with the fact that all hard decisions in the long-term national interest will create short-term winners and losers. Innovative public policy is unlikely to emerge from a broad consensus of all interest groups. It is important to listen, but imperative to act.

Our examination, then, leads us to the conclusion that while the government's initial conceptualization of economic strategy as articulated in its November 1984 paper was sound, the implementation of the strategy has been inadequate. Returning to the football analogy, if the entire team has endless huddles in which it argues about the next play because no one has a strategy or the discipline required to win the game, the ball will not move very far down the field. The challenge for the federal government in its second year is to listen to conflicting demands in the key areas of economic policy, and then act according to the long-term national interest. These key areas include the conduct of fiscal policy -- and its interaction with monetary policy -- and a few key areas of microeconomic policy, including trade policy and social policy, that play a major role in economic adjustment to a changing world.

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p. 3, 2nd column. First full sentence should read: If a credible strategy to reduce the deficit is not adopted....

p. 7, Table 1. Total direct expenditure charge should read: Total direct expenditure change

p. 7, Table 1. First column, second number from bottom should read: 5.2

If the government fails to act in these areas, there is a real danger that the economy's vulnerability to unanticipated changes in external economic conditions will increase; that Canada will continue to lose international competitiveness; that the best and brightest of its young may choose to seek better opportunities in other countries; and that interest-group conflict will intensify over the division of an economic pie that is not growing rapidly enough to satisfy everyone.

This issue of **Commentary** examines the government's strategy in these key policy areas and reviews major policy priorities for the coming year.

Budget Policy

The federal government has little room to maneuver in its conduct of fiscal policy as long as large budget deficits increase the federal debt and the cost of servicing that debt grows at a faster rate than the national economy is growing. While this continues, budget policy remains a captive of rising interest rates, and an increasing proportion of tax revenues must be diverted to pay the annual charges on the public debt. Rapid debt accumulation, therefore, increases the already severe pressures to cut other forms of spending or to raise taxes.

We reiterate that deficit reduction for its own sake is not the objective. Rather, it is a means to improve prospects for economic growth and job creation, and it can do this in several ways. First, reducing the deficit now can provide vital room to maneuver in cushioning the effects of the next recession. Second, as the Institute has pointed out in earlier publications, as long as the deficit remains at high levels, public-borrowing requirements can be expected to put pressure on real interest rates, or at least to prevent their downward movement as fast and as far as might otherwise be the case. Large federal government borrowing raises the demand on the pool of real savings and tends to undermine confidence in financial markets, both at home and abroad, which can then add to risk premiums. If a credible strategy to reduce the deficit is adopted, a given monetary policy also is likely to lead to higher real and nominal interest rates; persistent large deficits mean that monetary policy must be more restrictive than would otherwise be necessary to keep inflation on a downward trend. If the federal deficit were reduced, or if a long-term downward trend were established in a believable way, it would be possible to bring about a change in the policy mix: from a tight monetary and an expansive fiscal policy to an easier stance for monetary policy combined with more moderate fiscal policy; both changes would lead to lower interest rates. Finally, reducing the deficit would reduce pressures that attract Canadians to hold government debt instead of the more productive debt and equities of Canadian companies.

The government's November 1984 paper was a welcome document because one of its objectives was to seek to restore fiscal room to maneuver. The document correctly noted that "we have reached a point where normal growth in the economy is not in itself enough to pay the rising debt-service charges on the debt....prudent economic and financial management demands government action now to stop the federal debt from growing faster than the economy." To what extent has the government acted to restore its fiscal maneuvering room?

The May 1985 Budget

Against the expectations generated by the apparent strategic commitment of last November, the picture that emerged from the May 1985 budget was mixed. The budget was innovative in introducing a number of measures to remove obstacles to growth and to encourage a more decentralized, market-oriented industrial strategy. It did not, however, take advantage of Canada's improving economic performance, nor did it take decisive and credible actions to reduce the budget

deficit.

There were four critical constraints in shaping the budget. One was the need to ensure that budget measures did nothing to worsen Canada's persistent high unemployment. The second was the fiscal imperative of cutting the alarming rate at which public debt was accumulating. The third was to spread the burden of restraint as fairly as possible. The fourth was to make the best use of the remaining, limited, deficit-reduction options after most social-program reforms were ruled out in response to political pressures.

The measures proposed in the May budget were unlikely to prevent the continued decline of unemployment since the Western Energy Accord -- initiated before the budget -- the solid strength of the recovery, and the general improvement in economic confidence in Canada had created a significant growth momentum.

The budget attempted to come to grips with the deficit. But because of perceived political constraints on spending cuts and uncertainty about the international economic outlook, the budget's authors failed to choose measures that would credibly reduce the deficit very much over the next two years. Instead, they relied on temporary surtaxes that will keep the deficit from rising this year and next, and on measures -- such as sales tax increases and the partial deindexing of personal income taxes -- that will have a significant cumulative impact in later years.

Some budget measures unintentionally intensified interest-group conflict. Even the Minister of Finance's modest deficit-reduction target required measures to raise taxes paid by individuals and corporations and to reduce inflation protection for certain types of benefits. But to encourage investment activity, the budget provided for a modification of capital-gains taxation. Such a combination of measures invited the opposition of groups whose benefits were to be reduced. This conflict further increased with the realization that the partial deindexation of pensions meant that the purchasing power of the elderly -- many of whom are among the poorest Canadians -- would be eroded in future by inflation. After intense political opposition, the Prime Minister decided to restore the full indexing of the Old Age Pension. This revision to the budget meant that to meet the government's deficit-reduction target in the next two years, taxes on gasoline and corporate profits had to be increased. Additional expenditure cuts or tax increases are still required to meet the budget's original target for the end of the decade.

Our assessment of the May budget focuses on three aspects:

- its impact on growth and employment;
- tax changes;
- the accumulation of federal debt.

Impact on Growth and Employment

The budget incorporated measures intended to increase the flexibility of economic activity. It sought to restore market signals and to remove distortions and obstacles. Ending the "stacking" of grants and tax incentives represented a decision to rely increasingly on market signals to direct investment decisions. Reductions in industrial subsidies reduced risk-taking that was not in the national interest. Increasing pension portability and introducing tax-free employee loans enabling relocated workers to purchase new homes has removed significant obstacles to labor mobility. Some evidence of improved management of govern ment programs and services was apparent in the decisions to close heavy water plants, to improve cash and property management, to reduce somewhat the growth of the public service, and to sell or dissolve crown corporations that serve no clear public-policy purpose.

The budget introduced significant tax reductions to promote growth and encourage risk-taking. The capital-gains exemption was a clear signal to encourage Canadians, many of whom had previously been channeling their savings into low-

risk securities, to consider riskier assets on which capital gains might be realized in future. This measure was introduced in response to a widely held perception in the business community that a major reason for slow recovery in investment activity in Canada has been the under-capitalization of Canadian businesses. The government refrained from "gimmicks" designed to ensure that savings would be channelled only into capacity-expanding investments instead of into relatively unproductive personal assets such as real estate, art, and jewelry. It has faced criticism from skeptical analysts and groups -- such as consumers -- whose tax burden was increased by some of the budget's other measures. Some of this criticism is justified, as it is not clear that the capital-gains exemption will fulfill its intended objective of speeding investment activity. Use of the exemption should be monitored, but even if the desired response falls short of expectations, there is little the government can now do without severely damaging its credibility; the measure is here to stay. It is to be hoped that the risk the government has taken in introducing such a permanent measure will pay off in the national interest as intended.

Other tax reductions were introduced as part of the Western Energy Accord. Their intention was to remove what was believed to be a discriminatory and inflexible tax regime and thereby to stimulate employment through renewed exploration and development activities, particularly in Western Canada.

Tax Changes

The overall impact of the budget's tax changes is complex to evaluate because of the mixture of objectives they were intended to serve. Taxes were reduced for the petroleum industry, small business, and private investors in order to stimulate investment activity and job creation. Taxes were increased on other activities in order to raise revenues and restore fiscal flexibility.

Revenues were raised in two ways: by broadening the revenue base and by raising tax rates. Base-broadening measures included the wider application of the manufacturers' sales tax, a tax on chartered banks and trust companies, and the elimination of personal tax expenditures such as the RHOSP deduction and federal tax reduction. Tax rates were raised by temporary surtaxes on corporations and high-income individuals in order to spread the burden of deficit reduction. Reducing inflation protection for personal income taxes also amounted to an implicit increase in future marginal tax rates.

Many of these changes occurred at the expense of simplicity and equity in the tax system, so the final verdict on their economic impact should be based on whether they were the best possible ways to achieve the budget's objectives. Were they?

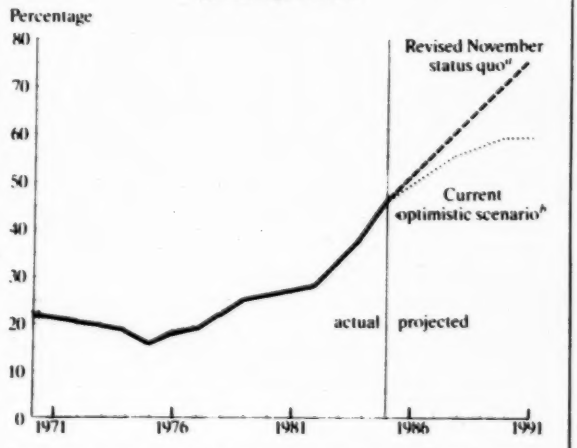
The shift to tax consumption-oriented activities more heavily and to lighten the taxation of investment and employment-oriented activities was consistent with the budget's long-term growth objective. But the decision to raise taxes in the first place was necessitated by the limited number of strategic options the budget's authors had for reducing the deficit.

The tax increases have two strategic implications. First, at a time when a major policy discussion is under way in the United States about simplifying the tax system and reducing personal and corporate tax rates, increasing direct and indirect tax rates that corporations and individuals face in Canada could mean a potential policy difference between the two countries that could make Canada a less-attractive place in which to work and invest. This matter will have to be watched carefully. Second, the timing of tax reductions so that they coincided with tax increases on consumers may have intensified interest-group conflict and weakened support for the budget's long-term priority of cutting the deficit.

Impact on Debt Accumulation

The government has made little actual progress in reducing the federal deficit or the rate at which the debt is accumulating. Instead, its actions, in both the November 1984 paper and the May 1985 budget, have sought merely to contain deficit growth. Technical documents released with the May budget indicated that the deficit was even more out of control than the government had suggested in November 1984. At that time, the government had projected that if no action were taken to deal with the deficit, it would remain in the range of $35-40 billion throughout the rest of the 1980s. But many economists felt that the interest-rate assumption on which this projection was based was too optimistic. The May budget assumed higher interest rates. It was then projected that, with no action, the deficit would rise to about $50 billion by the end of the decade.

FIGURE 1
The Debt-to-GNP Ratio, 1971–91: Alternate Scenarios
(percentage of GNP)



[a] Status-quo projection made by Department of Finance in November 1984, revised to incorporate less-optimistic "mid-range" scenario presented in May 1985.

[b] Based on Department of Finance "favourable" economic scenario presented in May 1985 and adjusted to take account of June 1985 pension decision and to exclude reduction in provincial transfers as discussed in text.

The implications of doing nothing were extremely serious. In the absence of policy changes in either November 1984 or May 1985, federal indebtedness would have increased much more rapidly than the economy's capacity to service the debt. Estimates based on the government's own mid-range projection indicated that the debt-to-GNP ratio would have increased to 75 percent in 1991 from 45 percent in 1985, as shown in Figure 1. Interest payments on the debt would have risen to 50 percent of federal revenues in 1991 from 35 percent in 1985. Such an outcome undoubtedly would have created a fiscal crisis that could only have been resolved by the adoption of much more severe austerity measures than any considered so far.

The actions the government has taken so far will reduce the deficit by $17 billion by the end of the decade and should be sufficient to keep the annual deficit in the $25-35 billion range during that time. This is no small achievement, but all that has been accomplished is to delay a possible crisis in federal government finances and it remains inadequate to remove the serious threat to the long-term growth of the economy that the Minister of Finance was so concerned about last November. More now needs to be done now if Canada is to reduce substantially its vulnerability to unanticipated shocks, recession, or interest-rate increases by the end of the decade, and if crowding out of future domestic investment by the private sector is to be avoided.

The methods the government uses to reduce the deficit further are crucial. Not all of them will have the same beneficial impact on private-sector growth. For example, private-sector activity can be encouraged both by reducing the government's claim on private savings and by eliminating government programs and regulations that are obstacles to efficiency and growth. But if the deficit is reduced primarily by higher taxes, private-sector activity will not be encouraged.

The Minister of Finance has asserted that 80 percent of the reduction in the deficit by the end of the decade will be on the expenditure side of the budget.

Despite this assertion, the significant increases in personal, corporate, and sales taxes have contributed to the impression that relatively little has been done to reduce spending on government programs.

TABLE 1

Budgetary Impact of Fiscal Changes since September 1984[a]
(billions of dollars)

Revenue Measures	Fiscal Year 1986-87	Fiscal Year 1990-91
Tax increases	5.8	10.8
Tax reductions	-3.3	-6.0
Net tax revenue change	2.5	4.8
Cost recovery	0.4	0.6
Total revenue change	2.9	5.4
Reduction in debt-interest changes resulting from revenue increases	0.3	1.7
Deficit reduction attributable to higher government revenues	3.2	7.1
Expenditure Measures		
Expenditure increases	1.4	0.9
Management savings	-2.5	-3.6
Reduced transfers to business	-1.1	-1.3
Reduced transfers to persons	-0.1	-0.4
Reduced program spending	-2.4	-2.7
Total direct expenditure charge	-4.7	-7.1
Reduction in debt-interest charges resulting from spending reductions	-0.5	-2.4
Deficit reduction attributable to reduced government spending	-5.2	9.5
Total deficit reduction	8.4	16.6

[a] We have calculated the contribution of reduced spending and higher revenues to deficit reduction slightly differently than the federal government did. First, cost-recovery measures are treated as increased revenues, rather than reduced expenditures through management savings as the government treats them. Second, the reduction in debt-interest charges is attributed proportionally to spending reductions and to revenue increase, instead of entirely to expenditure reductions as the government treats them.

Sources: Department of Finance, Budget Papers (Ottawa, May 23, 1985), pp. 30, 88-89; and estimates by the C.D. Howe Institute.

Table 1 provides an accounting of revenue and expenditure measures the government has adopted since it took office last September, including its decisions in June 1985 to restore full indexing of pensions, to extend the 5 percent corporate surtax, and to add a 1-cent-per-liter excise tax on gasoline. The accounting assumes that all of the other tax and expenditure measures will be implemented with the exception of reducing federal transfers to the provinces by $2 billion by the end of the decade. This number is excluded because these transfers have yet to be negotiated with the provinces and are therefore highly speculative.

These calculations show that about 60 percent of the planned $17 billion deficit reduction by the end of the decade will be the result of lower direct expenditures and their indirect effect on debt-interest charges. Of these reduced expenditures, savings from improved cash and property management, reduced inflation allowances for government-spending programs, and reduced reserves will account for about 60 percent; reduced program spending and transfers will be responsible for the remainder.

Higher taxes and user charges and their impact on debt-interest charges will account for almost 40 percent. The general perception that the government has relied heavily on tax increases is therefore supported by the statistics. Tax increases and increased user charges on individuals and corporations will raise revenues by $11.4 billion by the end of the decade. About $6 billion of these higher revenues will be offset by the capital-gains exemption and the phasing out of energy taxes that was announced in the Western Energy Accord.

Implications of the Current Strategy

Canada still requires a credible strategy to slow significantly the accumulation of federal debt by the end of the decade. The composition of existing deficit cuts relies heavily on tax increases. Relying on inflationary direct and indirect tax increases on corporations and individuals represents the easiest political route to deficit reduction. But it is also an outcome of a consultative process that could have negative consequences for the long-term national interest. For the time being at

least, the government has all but rejected the other strategic alternative -- a major effort to cut spending by making programs smaller and more efficient -- since this is the route that is more likely to offend one interest group or another, which the government seems loathe to do.

One important consequence of the government's inaction on cutting spending is that the size of the public sector in Canadian economic activity will not be reduced very much. In itself, this is not a particularly apocalyptic outcome. Nor is the continued diversion of savings to public-sector activities likely to have such negative or immediate consequences for investment and growth. Canadians will continue to muddle through for some time to come. But unless savings diverted to the public sector are used for productive investment activity, allocation of national savings in this way will neither move the economy towards its full potential nor reduce Canada's current, needlessly high unemployment rate.

Canadians now must either live with the consequences of the strategic direction that has been selected or take another look at the options. The government has gambled that its tax cuts on capital gains, energy, and small business activity will be sufficient to stimulate private investment and job creation. Our estimates of the remaining debt problem, however, lead us to doubt that what has been accomplished is nearly enough.

The Magnitude of the Problem That Remains

One consequence of continuing with the status quo is illustrated in Figure 1. Even under very favorable international economic conditions, public debt will rise to 60 percent of GNP by fiscal year 1990, compared to 45 percent in fiscal year 1985. Another consequence of the changes that were made in the May budget is a marked change in the composition of federal spending by fiscal year 1990, as Table 2 shows, even though

TABLE 2

Federal Expenditures by Major Policy Area, fiscal years 1981-91

	1980-81		1986-87		1990-91	
Policy Area	$ billion	%	$ billion	%	$ billion	%
Economic development	8.9	18.6	9.9	12.2	7.7	8.3
Social development	25.3	52.8	47.0	58.0	58.4	63.1
Defense and foreign affairs	6.7	13.9	12.7	15.7	15.9	17.2
Other	7.0	14.6	11.5	14.2	10.6	11.4
Total	47.9	100.0	81.1	100.0	92.6	100.0

Sources: Department of Finance, Economic Review (Ottawa, April 1986), p. 184; idem, The Fiscal Plan (Ottawa, May 1985), p. 26; and estimates for 1990-91 by the C.D. Howe Institute.

the impact on the deficit was modest. With no further policy changes, economic-development spending during the rest of the decade will drop to 8 percent of outlays -- excluding debt charges -- from nearly 19 percent. Social-program spending will account for more than 60 percent of total outlays by fiscal year 1990, compared to 50 percent in fiscal year 1980. Public-debt interest -- assuming favorable economic conditions -- will still account for almost 33 cents of every revenue dollar even with substantial tax increases, falling interest rates, and uninterrupted economic growth.

This is the picture of Canada's fiscal status quo. It may represent how Canadians wish to see their tax dollars allocated. But the problem that remains is that tax revenues cover a diminishing part of the bill. The rest is borrowed. The Institute recommends, therefore, that the entire matter of strategic options for further reducing the federal deficit be re-opened for debate.

Policy Priorities in 1985-86

Tackling the Federal Deficit

Choices for tackling the federal deficit can be expected to be influenced by strategic factors, political values, and political pressures. In its path-

breaking 1984 study of options for reducing the deficit, the Institute argued that the criterion for choosing spending and taxation changes be that they increase the value for money in achieving program objectives. The Institute further argued that the strategy be based on the principles of spreading the burden fairly, relying more on the private sector, preserving the social safety net and other public services people cannot provide for themselves, promoting lower interest rates, and reducing flaws in the tax system.

Observation of the public discussion in the past twelve months leads to the conclusion that Canadians have still to choose a strategy that reconciles the taxes they are willing to pay with the role of government and size of public spending that those taxes will sustain. It is the government's task to disabuse the public of any false hope that the two can be brought into line without any hard choices.

In view of the structure of government spending and transfers in Canada, three main strategic alternatives exist for cutting the deficit:

- Option 1, raise taxes only: because it would spare the spending side, this option would preserve the size of government.
- Option 2, cut spending growth only: this option would reduce borrowing requirements by reducing the size and scope of public-sector activities and transfers.
- Option 3, cut spending growth but more lightly in highly valued social programs: to reach a given deficit-reduction target, this option would require tax increases and heavy spending cuts in non-social programs.

In its November 1984 paper, the government attempted to open a debate that focused on slowing the growth of spending. The May 1985 budget, however, resembled Option 3. Perhaps Canadians have now begun to understand that if any major area of spending is to be spared from scrutiny, taxes must be raised. The government certainly has, for in reversing itself on pensions in June 1985, it raised taxes in order to preserve its modest deficit-reduction target, as we have seen. It has avoided Option 1 so far, but if it is to pursue Option 2, as seemed to be intended in 1984, Canadians will have to take another look at slowing the growth of all areas of spending and transfers.

A debate on options for reducing government spending, however, will have to begin on an entirely different basis than it did a year ago when it was dominated by conflict over cutting social-program spending. At that time, some groups recommended that in addition to cutting economic-development spending, selective social programs be substituted for universal ones. This suggestion was based on the belief that spending on social programs had increased beyond the level that taxpayers were willing to finance. It was felt that such programs could be redesigned to target the benefits to those most in need. Social-policy advocates disagreed with this prescription, convinced that more selectively targeted pensions, family benefits, and unemployment programs would erode public support for them and weaken the social safety net. Additional opposition appeared to the concept of applying savings from social programs to deficit reduction.

For the time being, the conflict over social-program cuts has been postponed by placing discussion of program reform off limits. Eventually, however, Canadians will have to reconcile the goals of fiscal and social responsibility, as articulated by the government last November. Indeed, the May 1985 budget attempted to do this in the only way the government had left open to itself: by slowing the growth of social programs through modified indexation of benefits. Yet, as Table 2 illustrates, the impact of policy changes made in 1985 will be to increase markedly the share of social spending in total outlays in the next few years.

So far, policy debates in Canada,

like many that have already taken place in Europe, have focused on restricting accessibility to social programs and shrinking their growth. But there are many choices for reforming these programs in ways that preserve universal access; these options have not yet been introduced into the public debate because they frequently involve the fine points of program design.

The options require more investigation and debate. Pension benefits, for example, could be taxed back from upper-income families. By the Institute's estimate, more than $1 billion could be saved by the end of the decade without endangering the social safety net or eroding the benefits for families below the median-income level. Reform of the unemployment insurance program to gear employer and employee premiums more closely to past experience with layoffs could reduce program spending in this area by another $1 billion without endangering the safety net.

Reforms in health and education program design are also worthy of closer public scrutiny. Allowing competition among health-maintenance organizations, fee-for-service systems, and hospital-based facilities could increase Canadians' choices for health care at the same time that competitive forces are encouraged that could provide more efficient, low-cost health care. By increasing the availability of student loans and freeing universities from existing regulatory ceilings on the size of tuition fees they are allowed to charge, financial pressures that force universities to apply for more public funds could be reduced at the same time that student choice is expanded.

Other expenditure areas -- including tax expenditures -- should not be exempted from the debate either. Indexation arrangements, for example, require a careful re-examination. The May budget's modifications to the indexation of personal income taxes and family benefits will allow future inflation to increase revenues and shrink the growth rate of real spending. The real issues that have yet to be addressed, however, are how to measure accurately inflation protection that is consistent with the real growth in the economy's ability to pay for such protection. The Consumer Price Index does not accurately measure changes in purchasing power because as the price level rises consumption patterns change, while the composition of the index does not. Until indexing more accurately reflects changes in productivity and terms of trade, against which people cannot be protected, these schemes will transfer resources into indexed transfer programs and away from the productive sectors of the economy.

While industrial subsidies that distort investment activity have already been cut, a moratorium should be established on granting new subsidies. The management of the federal public sector has still to be improved; the growth of the public service has merely been slowed. Deputy Prime Minister Nielsen's program review is a major hope for a strategy of expenditure reduction and increased efficiency in government. The government must listen to and act upon the recommendations of this exercise.

Will the Problem Disappear?

The government's strategic view of the future and the presence -- or absence -- of any air of fiscal crisis will affect the chances that these issues will be tackled with any vigor in the months ahead. Some argue that the problem will diminish because the international economic outlook is more favorable than the architects of the May budget assumed. This view is based on assumptions that slower U.S. growth will cause nominal interest rates to continue to decline, thereby reducing debt-service charges that are pushing up the U.S. budget deficit.

Another argument assumes that continuing softness in world oil prices can be expected to ease the debt burden of developing countries and increase the disposable incomes of consumers in the more developed countries. The positive impact that this would have on economic

growth in these countries could begin to offset the imbalances that foreign borrowing by the United States has built up in the past few years. Capital flows into the United States could be expected to slow down as alternative investment opportunities appear. The U.S. dollar could then be expected to weaken further, but not disruptively so. And perhaps most significantly, the protectionist tidal wave that is building in the United States could eventually be expected to lose some of its force as exporters and import-substitution activities regained competitiveness.

The Institute's assessment, however, is that the imbalance created by U.S. budget and trade deficits will take several years to unwind because of the lags with which new export orders appear and the time it takes to replace imports. Protectionist pressures can thus be expected to continue to build, and even worsen, for some time after the U.S. dollar weakens.

The implications of a positive international scenario for Canada are important. Slower U.S. growth will reduce the strength of exports as the engine of Canada's recovery. The decline in oil prices suggests we should expect less growth momentum from the petroleum industry, but more from consumers. Reduced inflation and lower nominal interest rates could be expected to have some impact on the federal government's debt-servicing costs and to slow the growth of both the federal debt and the annual budget deficit. Nevertheless, we agree with the government's assessment in the May budget papers of a similar favorable scenario.

We conclude that continued action on the federal deficit is required even if international economic conditions turn out to be unexpectedly positive. The federal government should, however, have a contingency plan to take advantage of such an opportunity. The current fiscal plan relies heavily on temporary tax increases to reduce the deficit. Many expect, however, that these increases will turn out to be permanent. In addition to continued action to slow the growth of spending, the government should use the opportunity to fulfill the promise of temporary tax increases and change Canada's tax system in ways that encourage entrepreneurial activity and greater flexibility in the economy's adaptability to change. Such a contingency plan is especially important because of the increasing chances of major tax reform in the United States.

Trade Policy

Tackling the federal deficit -- to restore fiscal flexibility and reduce vulnerability -- must continue to be an integral part of Canada's strategic policy framework. Even if the urgency of the debt-accumulation issue diminishes with lower real interest rates, however, Canada's vulnerability to a rapidly changing international environment will remain unless another key decision is taken: to change Canada's trade policy. A number of options exist but, as the Institute has stressed in its recent study on this question, one that does not is to continue the status quo. If present policies are left in place, global economic forces and rapid technological change will leave Canada in their wake. Few Canadians disagree with the need for changes in policy; they do disagree somewhat on what to do.

The choices are few and depend on one's view of the obstacles Canada faces in readying itself for the world of the year 2000. One obstacle is the rising tide of protectionism in the United States, which threatens Canada's access to the large U.S. market. Another is the competitive threat posed by the newly industrializing countries (NICs). At present, thousands of Canadian jobs still depend on export and import industries that compete directly with lower-cost products from the NICs. These higher-cost industries rely on trade restrictions to protect them against this competition. Yet the NICs are also among the fastest-growing markets to which to export. If Canadians wish to have access to those markets, we will also have to

accept their imports and step up our export-marketing efforts. This will mean phasing out our trade restrictions. At the same time, Canadians will have to move "up market" to produce products and services that NIC importers will want to buy. This in turn will require continuing change in Canada's industrial structure and in the structure of employment. These kinds of adjustments are best made in a growing, not a stagnating, economy.

What is required, then, is a major policy shift to ensure access to markets of more than 25 million people. Our analysis leads us to the inescapable conclusion that Canada should investigate with the United States options that would allow, on a gradual basis, expanded and more secure access to the U.S. market for Canadian producers.

There are several compelling reasons why Canada should commence negotiations with the United States as soon as possible. First, it is the only way Canada can quickly reduce its vulnerability to the rising tide of U.S. protectionist measures. Second, Canadian producers would no longer need to set up shop in the United States to get around U.S. laws requiring them to produce there if they wish to sell there. Third, and strategically most important, access to the U.S. market, because it would improve sales for Canadian firms, would create a growth dividend for the Canadian economy that could lubricate the adjustments inevitably required if Canada is to be competitive in the world of 2000.

Opponents of liberalizing trade with the United States argue that Canada's political and cultural sovereignty would be undermined, that Canada would lose investment and jobs, and that Canada would lose policy independence. These arguments, though based on legitimate fears, simply are not supported by factual evidence. Canadians are already vulnerable to U.S. political measures and economic policies. Canada is currently forced to harmonize certain policies to prevent retaliation or countervail. Treaty protection could create more policy independence than Canada now has. Indeed, a treaty might enable Canadian producers to obtain fairer treatment by U.S. courts than they now obtain.

Perhaps the greatest single concern is that Canada would lose investment and jobs in a free trade agreement. Again, neither reasoned argument nor available evidence support this view. The most thorough study of the evidence, by Richard Harris of Queen's University, shows that Canadian employment would increase by 5 percent in a free trade area because of increased market access. Many Canadians do not realize that Canadian firms and employees had to make even larger adjustments to the Kennedy and Tokyo Round tariff cuts -- yet employment increased and the economy grew. Canadian business organizations such as the Business Council on National Issues and the Canadian Manufacturers' Association -- recognizing opportunities for specialization, economies of scale and changes in product mix -- favor bilateral trade liberalization.

Some who argue against bilateral trade liberalization prefer that Canada look inward to its own market as a source of strength. The Institute rejects this inward-looking option. We see it as dangerously similar to the kinds of decisions Argentina took earlier in this century that are now recognized as directly responsible for that country's decline into economic chaos. In 1925 the Argentine and Canadian economies performed equally well. Since then, Argentina's real per capita income has grown by 65 percent, while Canada's has grown by 265 percent.

Others argue that Canada could avoid the perceived political risks of economic integration with the United States by pursuing multilateral trade negotiations. This option is not viable since, in the absence of other approaches, the negotiations would likely take ten years to complete; Canada needs to solve the problems it faces now.

The most sensible approach is to pursue the bilateral and multilateral

routes simultaneously. The two are complementary, and neither option should be, nor need be, foreclosed. Indeed, to do so could seriously weaken Canada's negotiating position in a bilateral arrangement, because the multilateral route is the most obvious alternative should Canada find the conditions of a bilateral negotiation unacceptable.

Canada's leaders must decide in the next few weeks whether to initiate negotiations with the United States. They must decide on the basis of the available evidence whether this route best serves the national interest. We want to emphasize that the decision to negotiate is not a decision to sign an agreement. Canada can still refuse to accept any conditions that clearly violate its political or cultural sovereignty. Adjustments by firms and workers, many of which must be faced anyway, can and must be provided for by positive adjustment programs and provisions for phasing in the elimination of trade barriers.

This decision is one of the most important any Canadian government has faced since World War II. Even if followed by a successful agreement, it will not be a panacea for all of Canada's economic problems. But it will be one of the most important means of making the structural changes required for success in the years ahead with the least serious dislocation for individual firms and workers. It is one of the few remaining chances the federal government has to demonstrate that it indeed has its eye on the ball -- a set of long-term strategic goals.

Conclusion

The government still has a few major opportunities to take policy initiatives that will improve the economy's long-term prospects. The report of the Macdonald Royal Commission provides such a strategic framework and key policy recommendations supported by high-quality research. All Canadians could be better off in the future if the government uses this report as the basis of decisive action in the months ahead. These are hard decisions, and they will create short-term winners and losers. But after listening to special-interest groups, the government must act in ways that serve the best interests of the nation. The test of success is not whether the entire crowd is cheering but whether the ball has been carried successfully over the goal line.

If the government does not make use of these opportunities, Canadians will face conflict over shares of an economic pie that will not be growing as rapidly as it could if sensible policies were pursued. A decision to negotiate a comprehensive trade agreement with the United States should be a key strategic policy element. Further commitment to reshape fiscal policy in a way that not

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The author of this issue is Wendy Dobson, Executive Director.

C.D. Howe Institute
125 Adelaide Street East
Toronto, Ontario
M5C 1L7

Telephone: (416) 865-1904

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only slows the accumulation of debt but also restructures spending and taxation to promote growth in productive capacity is another. The deficit cuts in the May budget will only be sufficient to contain annual deficits in the $25-35 billion range during the rest of the decade. The Macdonald Commission's innovative suggestions for social policies should also be used as the basis for a more-creative debate about reform in these areas. Such a debate can explore better ways to achieve objectives on which everyone agrees, ways that are more efficient and, in many cases, that enhance the safety net and individual freedom of choice.

The federal government is steward of the national interest, not just a conciliator among competing special interests. It has been correct to encourage debate of realistic policy options, but it now has an even greater responsibility to future generations to see that the debate leads to actions that serve the national interest.